

Date: 19th June 2008

The Frontier Markets Fad could boost Sri Lanka

A somewhat more positive near term equity view

Previous View was extremely bearish

On the 13th of March 2007 in our Asset Allocation Summary View report, we strongly reiterated our very negative view on Sri Lankan Equities that we had at the time stating that *“It would be nice and reassuring to tell you that this is a healthy correction, and that you should buy into the fundamentally sound “blue chips” at “bargain” prices today. We could also compare “relative” multiple valuations in Colombo with the regional markets and say the “market is cheap” and say that the fundamentals of the economy are strong and due to that you should buy equities. But we won’t. In our view, investors should continue to switch out of equities into long term fixed income. We believe the valuation the overall equity market is trading at is still not attractive especially when compared with the very attractive pricing available on long term fixed income today.....Thus even our favoured picks within equity may only outperform a falling market but provide negative absolute return in the near term. We would continue be extremely selective in recommending equity investment for absolute return at this point”*

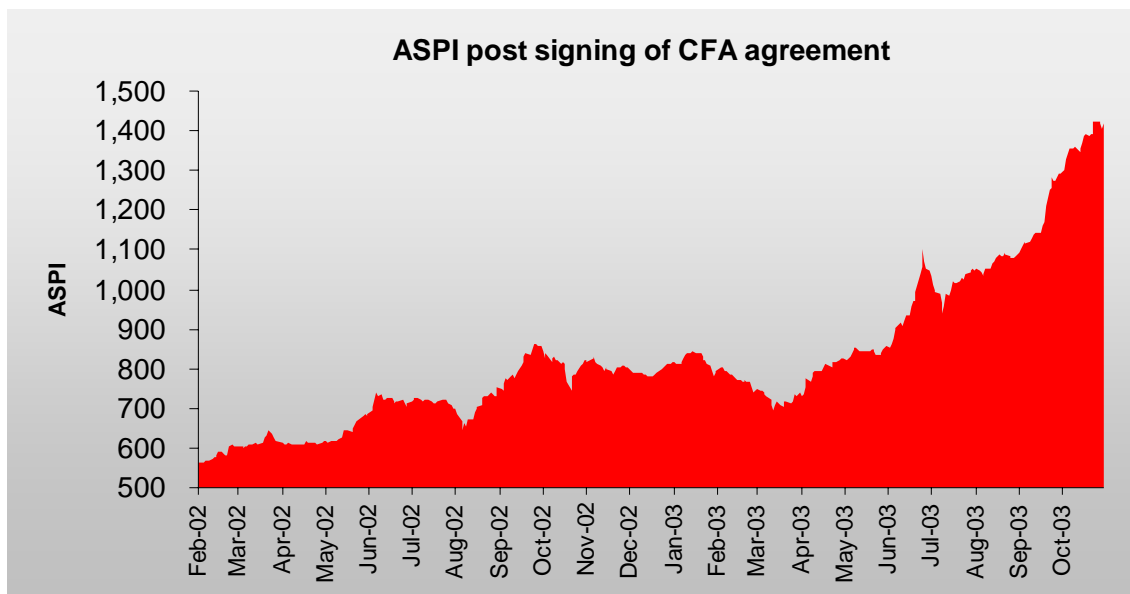
Less bearish now

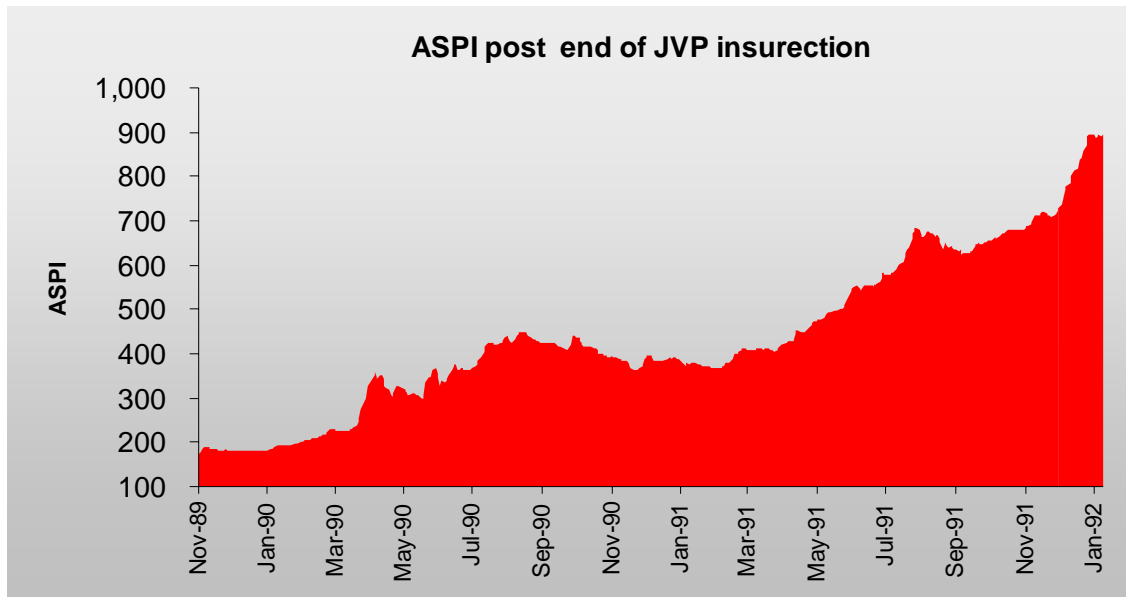
This bearish stance we took on equity over an year ago and later reiterated in views within our company reports, has largely proved correct. We are however now taking a somewhat more positive view on asset allocation into equity. We now feel specific stocks have started to look quite attractive. In the near term we feel equities seem somewhat oversold and with a continuation of FII investment into Sri Lanka on the current global Frontier Markets theme we feel could see a

short bear market rally. This we feel could take the ASPI up by around 7% from Tuesday close, some time in the second half of this year. Our favoured stocks could be up by a greater magnitude than this in this time horizon. On a one year horizon however our market call and ASPI target is however for it to be lower than it is today on account of the continued macro uncertainties as well as the fact that valuation are not as cheap as they have often been historically during the deep bear phases in Sri Lanka's equity markets history. Thus we term our positive view of market action in the second half, a call of a bear market rally.

Risk of being out of equities if there is peace.

This whole view of course on an assumption that the conflict continues at its current intensity. However from an asset allocation perspective investors should also take into account the risk of been completely out of equity, in event peace were achieved by some means and sparks a huge rally in the market as has been seen in the past post the signing of the CFA agreement or further back following the end of the JVP insurrection. Therefore even taking a one year forward bearish view on equity as a base case scenario, we feel investors should be cautious in having a zero weight age to equity.



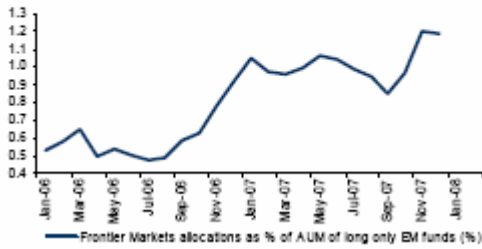


Success of Safari Com IPO in Kenya seems to suggest Frontier Markets boom still has more legs more to it.

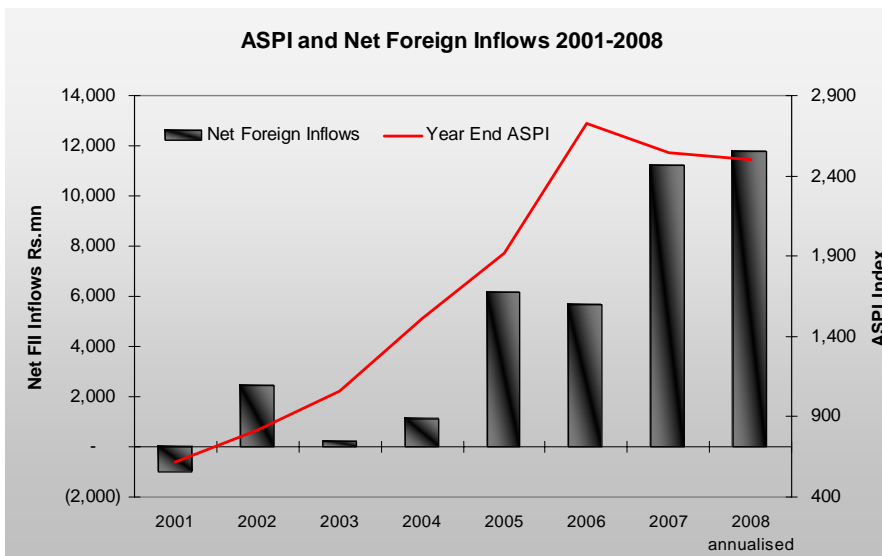
This more positive view on the market is sparked by the tremendous success of the Safari com IPO (the leading mobile telecom operator) in Kenya. This seems to suggest to us that that the recent “Frontier markets” investment fad, still has some legs more to go, though as with any over-hyped asset class we fear that the bust after the boom for the Asset Class could be painful.

The continued net FII investment’s into Sri Lanka despite the macro and political uncertainty in our view is very much related to the Frontier Asset Class gaining greater prominence. In the last nine months, MSCI, S&P and Merrill Lynch have set up Frontier Markets indexes. New funds dedicated to “Frontier markets” as an asset class, to specific sub regions or specific countries seem to pop on a regular basis and global fund manager holdings in Frontier markets have been on the rise with net FII inflows been positive in many markets just as they have been in Sri Lanka.

Chart 5: EM Fund Managers holdings in Frontier Markets as % of AUM

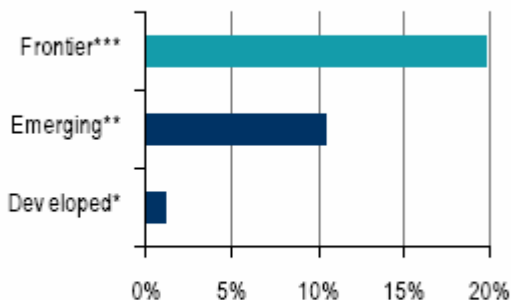


Source: Merrill Lynch



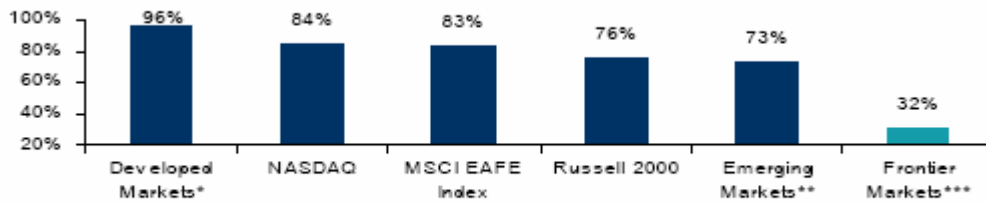
The story for the asset class told is one of very high returns historically beating both emerging and developed markets, while diversification benefits are seen in terms of low correlations with other markets.

Chart 1: 8 Year Annualized Returns



Source: Bloomberg. *MSCI World Index. ** MSCI EM index. ***S&P Frontier Markets Index.

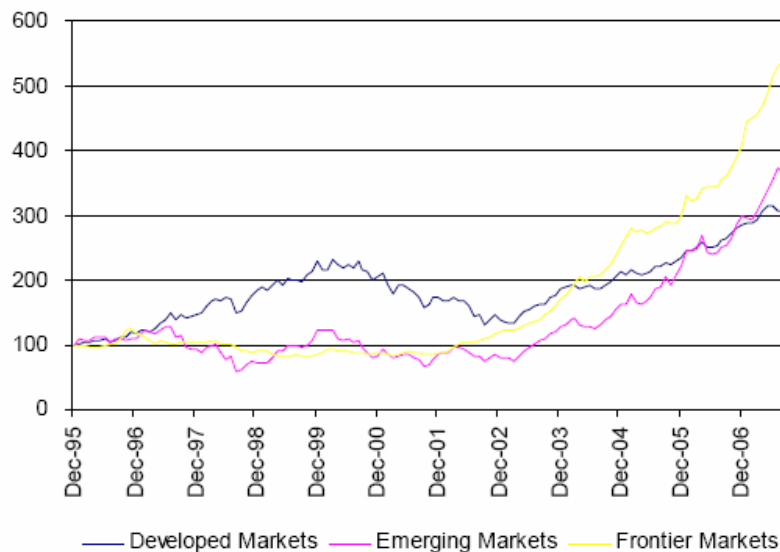
Chart 3: Monthly return correlations vs. the S&P 500



Source: Bloomberg. Data from Feb-2000 to Dec-2007.*MSCI World Index. ** MSCI EM index. ***S&P Frontier Markets Index.

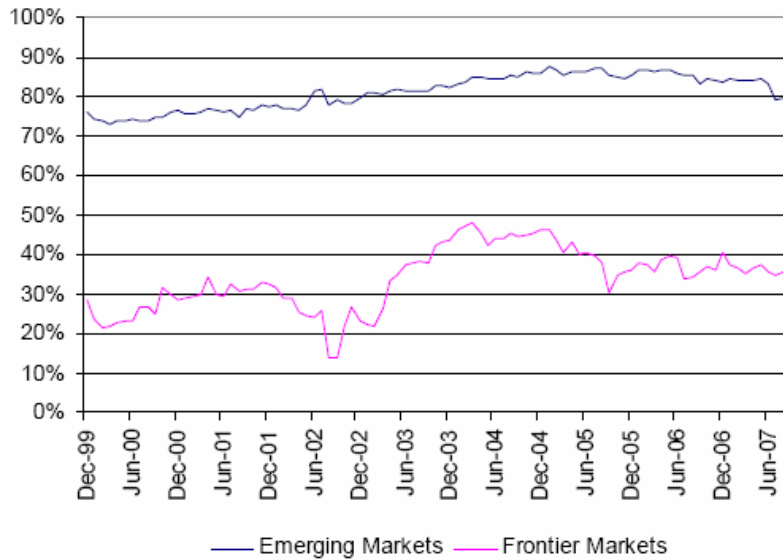
Source: Merrill Lynch

Exhibit 5: Value of US 100 Investment in Developed, Emerging and Frontier Markets.



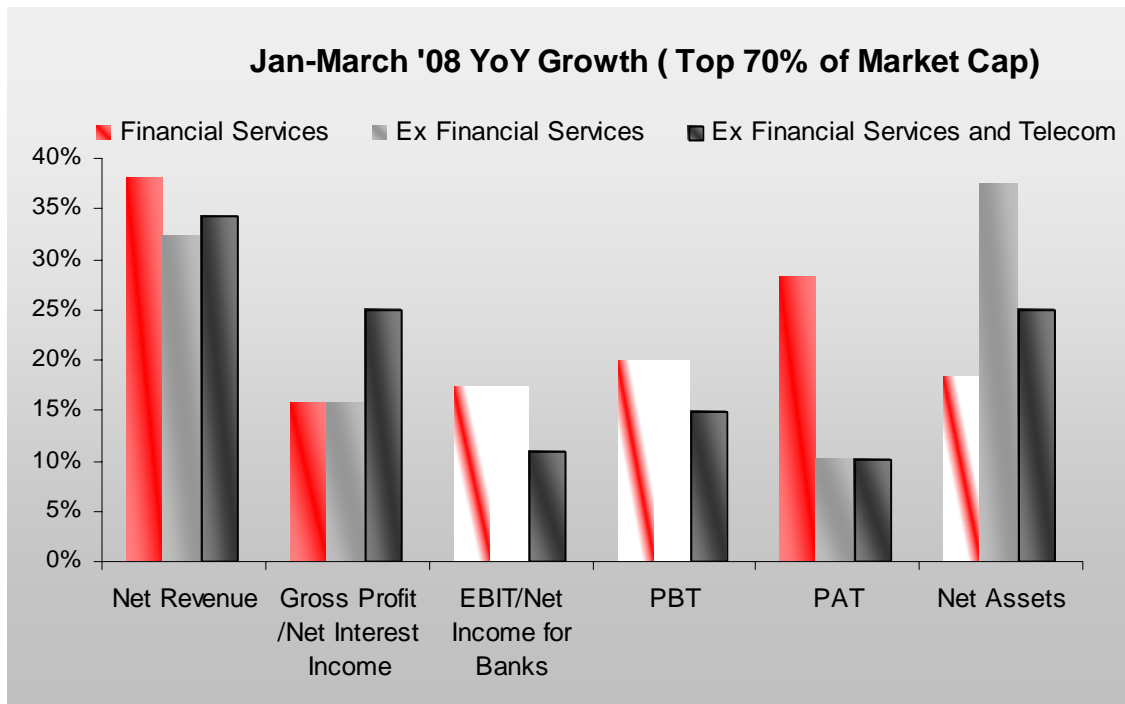
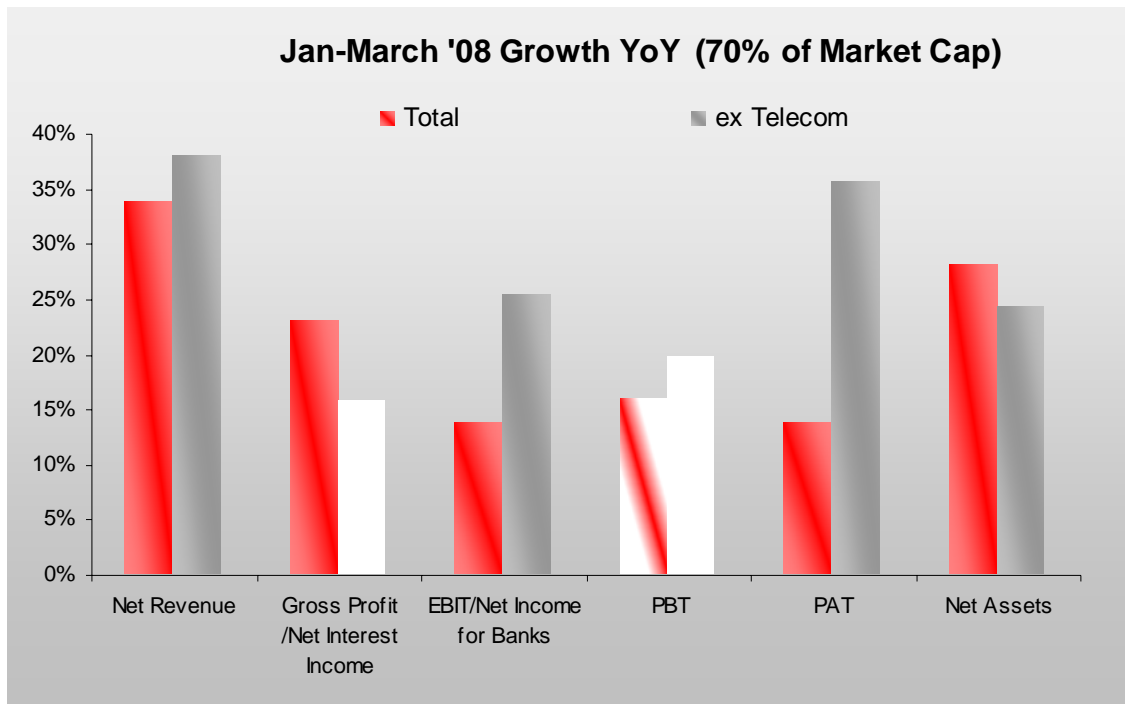
Source: Standard & Poor's. Emerging markets are represented by the S&P/IFCI Emerging Markets Composite and frontier markets by the S&P/IFCG Frontier Markets Composite.

Exhibit 4: Rolling Four-Year Correlations Versus Developed Markets



Source: Standard & Poor's. Emerging markets are represented by the S&P/IFCI Emerging Markets Composite and frontier markets by the S&P/IFCG Frontier Markets Composite.

Furthermore given the extremely bearish sentiment that seems to grip the market today with regard to the macro outlook and corporate earnings, positive surprises in the market are a possibility on a general basis even if the actual news is bad. This despite the continued sharp underperformance of the telecom sector we continue to expect. Thus some degree of positive earnings growth as we have seen in recent quarters, would surprise investors who might be expecting negative earnings growth.



Does this make us bulls on Sri Lankan Equity. Not at all. Given the returns in fixed income this is hardly the kind of market call we consider bullish particular



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given the risk factors involved and the extent to which the call is related to a view on global investors have on “Frontier markets” as an asset class. Over the medium term horizon of one year, a potential reversal of FII flow that have come into Sri Lanka based on the “Frontier” story, will most likely lead to the market loose any gains it might make in the next few months, and then more. But in our view, given the likely strength in the second half, and the possibility of peace at some point we feel now is a time investor should strongly consider raising exposure to specific corporate names we like.

Stocks we like

From our Core Coverage, we have issued positive recommendations on Hayleys, HNB Non Voting Shares, NDB, DFCC,.CTC and Lanka IOC while another large cap stock we have do not have in coverage which we like is Hemas. Given our view on the market direction we suggest that investors use the current market downturn as an opportunity to slowly accumulate holdings in these stocks.

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